FEDERAL HOME LOAN BANK
OF CINCINNATI

TESTIMONY BEFORE
FEDERAL HOUSING FINANCE BOARD

APRIL 11, 2002

Dr. Charles L. Thiemann

On behalf of the Board of Directors of the Federal Home Loan Bank of Cincinnati (FHLBank), I want to express my appreciation for the opportunity to discuss the key elements of the Cincinnati capital plan proposal. This plan is undoubtedly the most important issue our Board has dealt with in many years. The form of the capital reorganization will have long-term and lasting consequences on the ability of the FHLBank to fulfill its housing and economic development mission through its member institutions.

As we are all aware, Gramm-Leach-Bliley (GLB) dramatically altered the workings of the Federal Home Loan Bank System by devolving much of the governance of each Federal Home Loan Bank to its local Board of Directors. In the case of capital restructuring, the FHLBank's Board was charged with developing a plan that best suits the needs of Fifth District shareholders within the constraints of Bankwide capital requirements and the need to maintain safety and soundness of operations. Our Board took this charge quite seriously and began its work immediately following the passage of GLB. Beginning at its annual planning conference in January, 2000, the Board began a year-long process of developing the key elements of its capital plan. The core objectives of the plan were (1) establish a capital framework that promotes the FHLBank's public/private mission, (2) maintain safety and soundness, (3) enhance membership utilization of services, (4) reorganize in a manner that is tax-free to the member, (5) preserve the favorable tax treatment of past and future stock dividends, and (6) enhance the flexibility of FHLBank's management of capital and earnings. An initial draft of the plan was adopted by the Board in February, 2001. The FHLBank's outside counsel, Taft, Stettinius, & Hollister, has been involved throughout the process to ensure the plan is in complete compliance with GLB and ensuing Federal Housing Finance Board (FHFB) regulations. The draft plan before you today was, in fact, written by outside counsel.

Following the development of the core elements of the plan, the FHLBank's Chairman, President, and Executive Vice President conducted a series of 10 seminars throughout the District in the Spring of 2001 to explain the plan to member institutions and to receive their feedback. Several industry and public interest directors also took part in these discussions. Two detailed brochures explaining the plan were also mailed to all members prior to the seminar series. In addition, a pro forma analysis was prepared for each member detailing the impact of the plan on their particular institution. The initial draft was also shared with the Office of Policy in March, 2001. Following the member outreach program, the FHLBank finalized its draft plan and submitted it to the FHFB in July, 2001. A slightly revised version was submitted to the FHFB in January, 2002 in light of revisions to the capital regulations in November, 2001. However, the latest version of the plan is essentially the same as the one presented to our members a year ago.

The Cincinnati Bank's Board of Directors and its legal counsel are confident the proposed plan clearly meets the mandates of GLB and FHFB regulations. In examining the Federal Home Loan Bank Act alone, it is clear that, although there are provisions that speak to the need for individual members to invest in the capital stock of the

FHLBanks, these obligations are only part of the overall requirements governing the FHLBanks' capital structures. Sections 1426 (c)(l)(A) and (B) of the Act require "each member" of an FHLBank to maintain a minimum investment in the stock of the Bank. However, §1426(c)(l)(C) and (D) provide that the individual obligation need only be set at a level that is "sufficient for the bank to meet the minimum capital requirements established by the Finance Board…." The emphasis of Congress is on the obligations of the FHLBank, rather than any individual member, to meet minimum capital ratios, risk-based capital standards, and other requirements of the Act. The FHLBank believes that the capital regulations and the FHFB's accompanying explanation are consistent with this view (§ Fed. Register 8262 et. seq. January 30, 2001). The Supplementary Information section states that the Finance Board wants to "[afford] each Bank the latitude to tailor its minimum investment to the needs of its members, and, further, that the Finance Board recognizes that each Bank may have a different operating philosophy and may wish, for example, to establish relatively lower activity-based stock purchase requirements and relatively higher member stock purchase requirements or vice versa" (§ Fed Register 8304). Other language found in the comments is fully consistent with the concept of meeting capital requirements on a Bankwide basis. On page 8276, for example, the FHFB states: "as a fundamental matter, the Banks are cooperatives which means that the capital to support the business of the Banks must be supplied by the members of the cooperative." The explanation further spells out members' responsibilities by saying "as members of a cooperative, the members of a Bank have an obligation to provide the Bank with the capital that the Banks are required to hold in order to support the risks attendant to the business that they conduct with their members” (page 8305). The Act and the regulations clearly direct that the members of the cooperative must supply the capital necessary to meet Bankwide capital requirements which is precisely the case with the Cincinnati plan.

The theory of the cooperative organization is readily apparent throughout the FHLBank’s plan. It contains well-defined membership and activity-based stock requirements that ensure the FHLBank will meet or, as will likely be the case, far exceed the minimum Bankwide capital requirements found in GLB. The plan is unique in the sense that its activity requirements are proposed as a range of values, rather than a point value, depending upon (among others) the existence of excess stock previously issued by the FHLBank. At the time of implementation, all members would face a minimum total activity requirement of two percent of advances or acquired member assets. This two percent requirement would be in effect as long as FHLBank excess stock was available. When such excess stock is exhausted through advance and acquired member asset growth, the minimum activity requirement automatically jumps to four percent for any new transactions and can be adjusted to as high as six percent by action of the Board of Directors. This aspect of the plan is referred to as “cooperative capital” and truly represents the spirit of a cooperative institution where members supply the necessary capital to operate the enterprise. It is important to recognize that a portion of the capital raised by the FHLBank has been through the payment of stock dividends, a practice begun in the late 1970s. The vast majority of these dividends has been maintained as stock by the members over the years and has been utilized to capitalize, among others, long-term advances, mortgage-backed securities, housing agency debt issues, and mortgage notes purchased from member institutions. The FHLBank is quite confident members will not suddenly begin to ask for redemptions of excess stock. Since our plan was announced to members, the excess stock balance has actually grown as virtually all members have maintained their most recent stock dividends in the form of stock. This growth has occurred despite the fact that the put option will increase from six months to five years upon plan implementation. In the unlikely event the membership chose to request redemption, the FHLBank could easily repurchase this stock by drawing down liquid investments and still remain well above GLB capital minimums. Despite the obvious willingness of members to hold excess stock, the latest version of the plan removes any excess stock redemption requests from the pool of cooperative capital.

The cooperative capital component of the plan is designed to encourage increased member activity with the FHLBank in the form of advance lending and mortgage note purchases without forcing unwanted repurchases of excess capital by the FHLBank. The plan will allow the FHLBank to reduce its current position in liquid investment securities and avoid the unfavorable tax consequences for members associated with the repurchases of excess stock. The plan will result in a balance sheet that consists primarily of mission-related assets and the liquidity necessary for operations. It will increase returns to shareholders which in turn will expand the FHLBank's contribution to its Affordable Housing Program. The end result will be an institution with greater value to Fifth District institutions, one that is even better equipped to meet its mission of providing funds for housing and community economic development throughout Ohio, Kentucky, and Tennessee.

In conclusion, the Cincinnati plan was carefully crafted by its Board of Directors to increase the FHLBank's ability to fulfill its basic mission while being fully compliant with legal and regulatory requirements. The plan emphasizes the FHLBank's cooperative nature by the use of cooperative capital, yet it requires well-defined membership and activity requirements which address the desire for a certain degree of commonality among the 12 FHLBank plans. The plan will result in an enhanced mission-related balance sheet for the FHLBank and a more valuable and useful enterprise for the voluntary institutions who supply the necessary capital for operations. Based upon our extensive outreach program and literally hundreds of one-on-one meetings with shareholders, we are confident the membership strongly supports the Cincinnati capital plan.